Basics of Private Trust

Concept, Creation, Care

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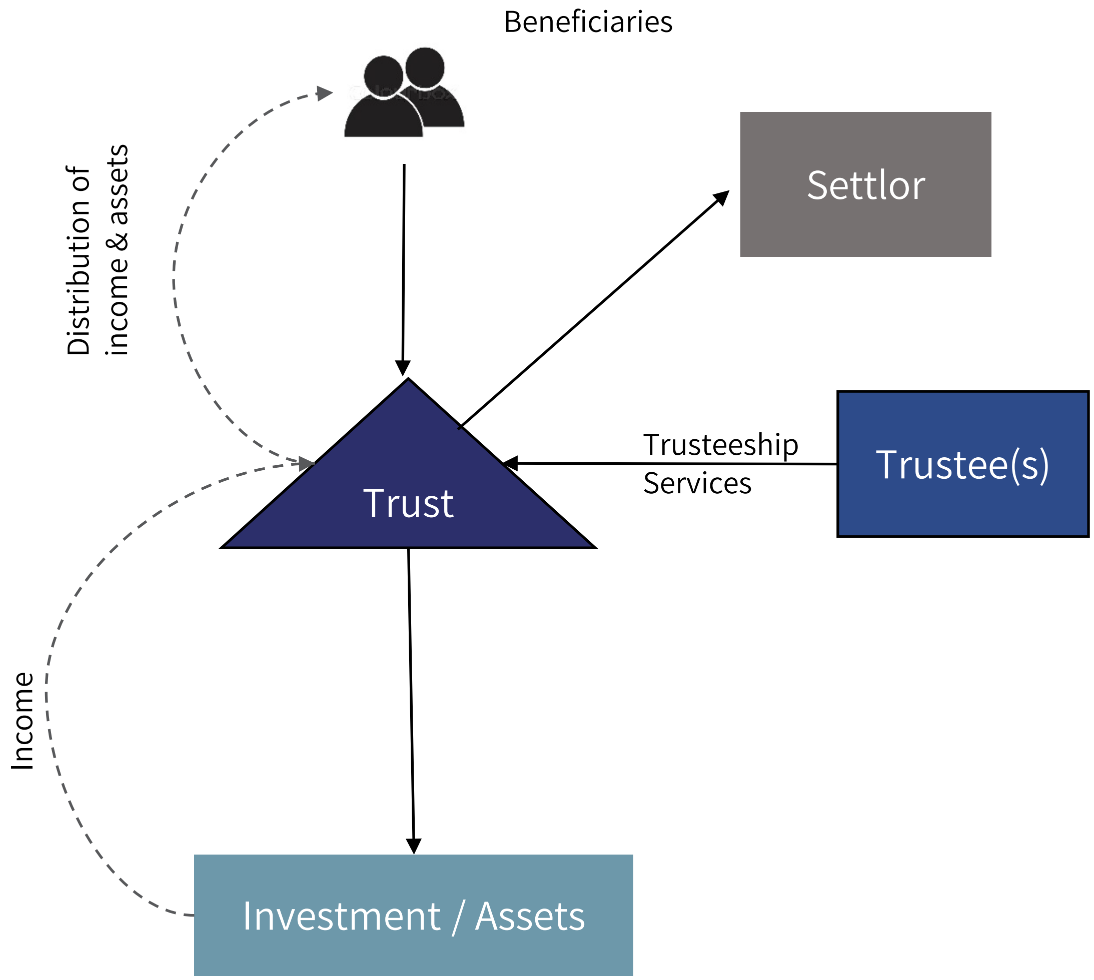
Trust - Meaning

Trust Structure



- Section 3 of the Indian Trusts Act, 1882 ('ITA') defines **'Trust'** as:
  "an obligation annexed to the ownership of the property, arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him for the benefit of the another, or of another and the owner"

- **Trust** is not a separate legal entity. It is an obligation casted on the trustee by the settlor to employ the trust assets for the benefit of the beneficiaries
  - Specific Trust where the shares of beneficiaries are specified
  - Discretionary Trust where the distribution to the beneficiaries is at the discretion of the trustee

- **Settlor / Author** is the person who settles the trust. He can be a trustee or a beneficiary as well

- **Trustees** are the persons who are bestowed with the responsibility of managing the assets of the trust and rights and powers for wealth distribution

- **Beneficiaries** are the persons for whom the trust has been settled

Discretionary Trust widely used as a holding vehicle

Trust Parties – Settlor

- **Settlor** to be a person competent to contract
- **Role of settlor limited** – except in case of revocable transfers wherein settlor retains some rights
- **No concept of one settlor one Trust**
  - even a subsequent donor appears to be treated at par with the Settlor with respect to property contributed
- **Settlor can be one of the beneficiaries** but not the sole beneficiary of a trust
  - Exposure of being regarded as revocable transfer?
- **A person can be the settlor and a trustee** or one of the trustees
  - The same individual cannot assume all three roles, since no trust can exist where the entire property is vested in one person - *"There cannot be a case where the creator of the trust would also be the trustee and <u>also the sole beneficiary</u>, because in such cases a man cannot enforce a trust against himself"*#

 # Bhavna Nalinkant Nanavati vs. CGT (2002)174CTR (Guj)152

Trust Parties – Trustee

- **Trustee** to be – all living natural persons or legal persons - competent to contract
- **Trustee is the legal owner of the trust property**
- **No restriction on number of trustees**
    - Exception: Minimum 2 trustees in case of a trust involving receipt and custody of money
- **Trustee can also be beneficiary** of a trust
- **Non-resident trustee whether permissible**?
- **Co-trustees cannot act singly unless specifically provided**

Trust Parties – Beneficiary

- The ITA defines the term ‘**beneficial interest**’ or ‘interest’ of the beneficiary as a right against the trustee who is the owner of the trust property
- **No restriction on number of beneficiaries**
- Every **person capable of holding property can be beneficiary**
  - A **minor / a person with mental disability** can be a beneficiary
  - **A trust can be a beneficiary in another Trust**
- Possible to provide beneficial interest in the trust property to the exclusion of some beneficiaries and some to have interest only on the income arising from property

Trust : Illustrative Roles of Parties involved

- **Role of the Settlor**
  - Generally, a Settlor has no role to play in the operations of the Trust
  - Settlor to decide on the Original Trustee, the Trust framework and initial beneficiaries of the Trust

- **Duties & Powers of the Trustee**
  - To operate the Trust as per the objects of the Trust
  - To buy / sell property and invest the Trust money and monitor the investments
  - To distribute income / assets of the Trust
  - To get reimbursement of expenses incurred while executing objects of the Trust
  - To add or remove beneficiary
  - To add further Trustees

- **Entitlements to the Beneficiary**
  - Enjoy profits of the Trust property
  - To expect the Trustee to properly protect and administer Trust property
  - To compel the Trustee to perform his duty properly
  - To expect a distribution (in case of a discretionary trust)

Types of Trusts

Specific Trusts v. Discretionary Trusts

- Trust deed of a specific Trust provides a list of beneficiaries specifying their beneficial interest in the Trust property / income
- Trust deed of a discretionary Trust does not identify specific ratio, but empowers a trustee or other person to determine the share of beneficiaries

Revocable Trusts v. Irrevocable Trusts

- In revocable trusts, the settlor reserves the power to reassume the Trust property / income
- In irrevocable trusts, the assets settled no longer belong to the settlor and it belongs to the Trust. Once properties are transferred to such trusts, it is certain that such assets at some time will be distributed to the beneficiaries

Types of Trusts

Testamentary Trusts v. Non-testamentary Trusts

- Testamentary trusts are trusts created under a Will and are subject to Indian Succession Act, 1925
- Non-testamentary trusts are trusts settled and executed by a settlor during his lifetime

Oral Trust v. Written Trust

- Oral Trust means a Trust which is not declared by a duly executed instrument in writing
- Written Trust means a Trust which is settled by way of a Trust deed

Discretionary Trust : Key features

Key Features

- Under a discretionary trust, the shares of the beneficiaries are not defined in advance. i.e. to say while the beneficiaries are listed out in the deed, the amount of distribution to be made to each beneficiary would be as per the discretion of the trustee
- Trustee has absolute discretion as to the application or distribution of income or property in favour of one or more beneficiaries
- The beneficiary has no right to demand any distribution of the assets / income of the trust
- The beneficiaries have the right to compel the trustee to perform his duties as per the trust objectives
- The power inter-se trustees can be defined as may be desired in advance for smooth implementation - It is possible for one trustee to have more control / administrative authority than the other
- Distribution pattern for day-to-day expenses can also be provided for
- Scenarios can also be built in for compulsory distribution e.g. for medical needs, education for children etc.

Trust is required to obtain a separate PAN, Bank account and Demat account
It is also required to file its Income-tax Return annually

Benefits of trust structure

- Clear Segregation of Control and Ownership
- Smooth transition of management
- Facilitate clear line of succession
- Assessing correct valuation of business and wealth
- Preservation on intrinsic value of businesses
- Maintaining of recognized family interest
- Regulation on third party entry into family business
- Flexibility for Future Generations
- Planning for inheritance taxes

Trust v. Will

Particulars	Will	Trust
Succession Planning	A Will can only be executed / operational after the death of the Transferor	The Trustee controls and manage his wealth during his lifetime
Disposition of assets after death	• Will can only provide for disposition of assets in existence as on a particular date (i.e., date of demise) • Disposition under a will is through the probate process which is granted to the executor from the Court on the death of the testator	• Trust Deed can provide for disposition / governance of existing as well as future assets / future income arising from such assets • In case of a Trust the property will vest with the beneficiary as per the Trust deed
Execution	Making of a will does not attract stamp duty - transfer of property to legal heir?	Making of a Trust will not attract any significant stamp duty except in the case of transfer of immovable property to the Trust
Modifications	Will can be amended, and the latest Will would apply	The trust which is settled should be irrevocable (can be discretionary or non-discretionary) for tax efficiency. However, the deed should be carefully drafted to avoid any future amendments
Estate Duty	Considering the Estate duty law internationally, normally estate duty is payable on inheritance	May be possible to mitigate Estate Duty through creation of Private Discretionary Trust, depending upon the local laws

Imperative to structure Succession Planning to mitigate levy of Estate Duty

Creation of Private Trust

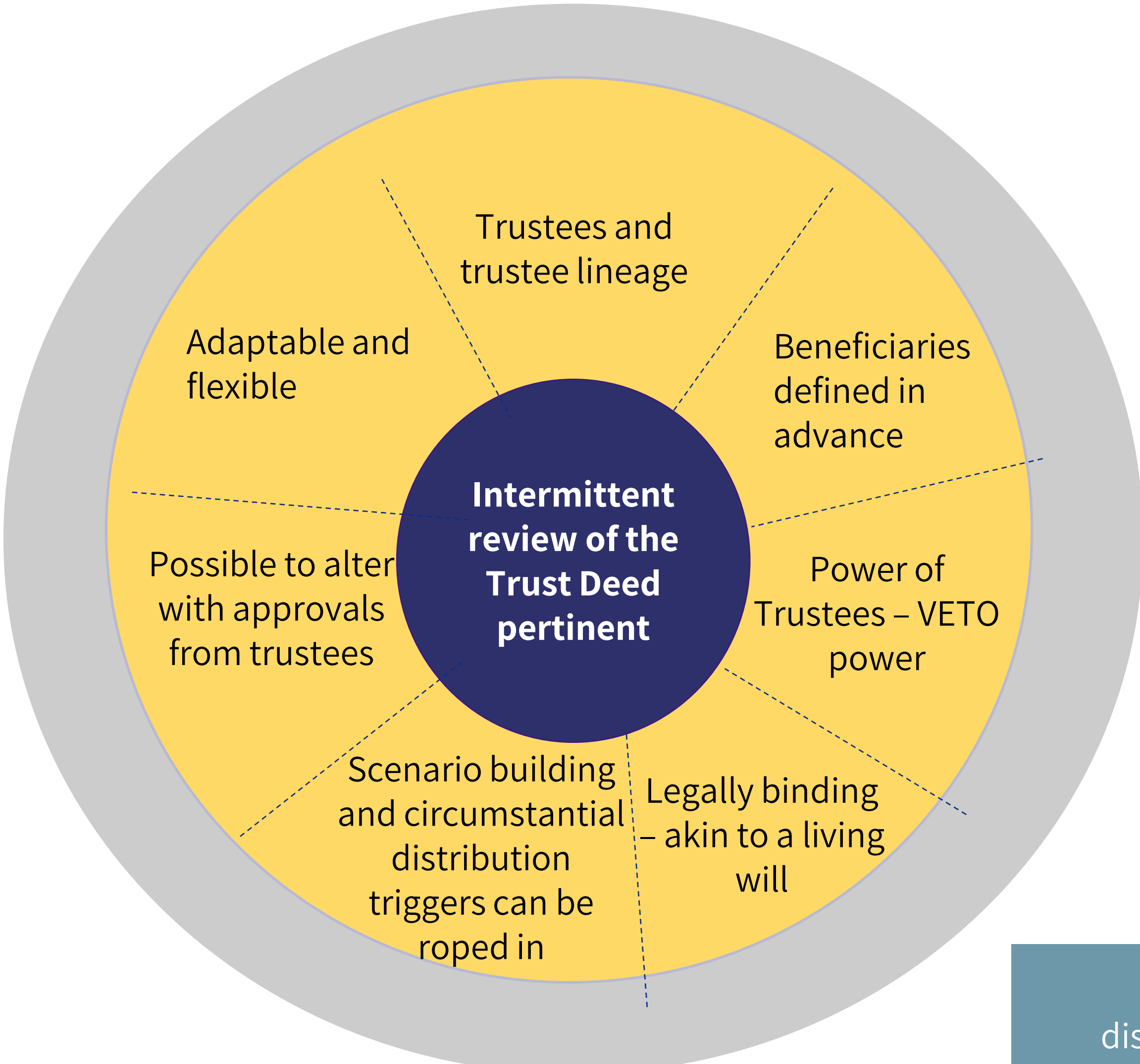
Who can create a Trust?

- A trust is created when the settlor or author of the trust indicates with reasonable certainty by his words or actions the following:
  - an intention to create a Trust
  - the purpose of the Trust
  - identification of the beneficiaries
  - identification and settlement of trust property

- A trust may be created by:
  - every person who is competent to contract
  - with the permission of a principal civil court of original jurisdiction by or on behalf of a minor

A mere intention to create a trust is not sufficient. An intention must be followed by action on the part of the settlor to create the trust

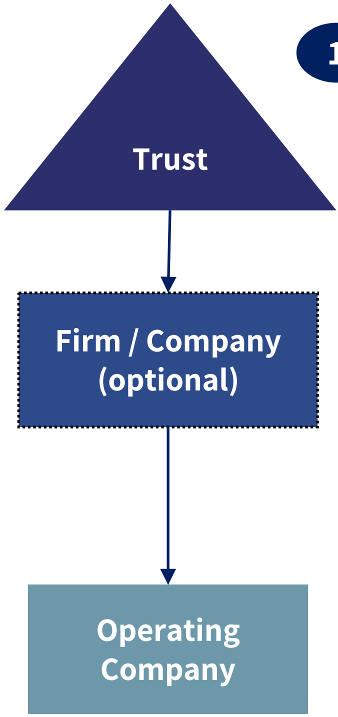
Trust deed: Key constituents



- **Trust document – defines governance framework**
- **Possible to lay down rules for income and wealth distribution**
- **Distinction between control and ownership under a single entity**
- **Distribution of assets and income from trust – can be designed in desired manner and to be tax efficient**
- **Minimal regulatory compliance**

Trust deed provides the needed flexibility to address distributive rules vis-a-vis different circumstances and lay it out in advance to avoid any dispute / litigation

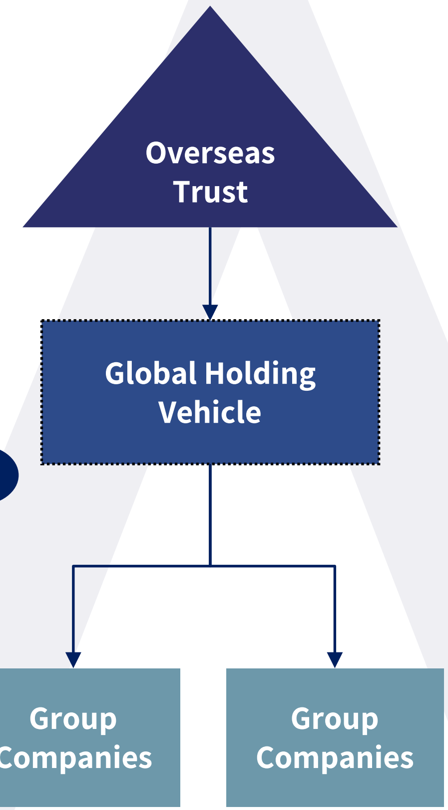
Local v. Offshore Trust



1 **For business activities concentrated in local geography**

- Settlement of assets in trust not subject to tax
  - Stamp duty costs to be evaluated
- Trust deeds usually provide for distribution of assets among family members
- Control with the trustees
  - Distribution of income without necessarily distributing control / wealth possible
  - Tax efficient distribution of income

Business interests spread across multiple geographies **2**



- Ambitious plans to expand foothold overseas markets
- Multi-dilution strategy for different business in different geographies
- Geographical de-risking of wealth
- Preference of Professional Trustees for Global Wealth management

Offshore Trusts – Jurisdiction selection

Following illustrative factors may be considered while deciding the jurisdiction for settlement of an offshore trust:

- Permissibility of settlor also being a beneficiary in the trust
- Retention of control of the trust by the settlor
- Protection of trust assets in the event of bankruptcy of the settlor
- Permissibility of spendthrift beneficiary provisions viz. protection of trust assets from liabilities of the beneficiary
- Protection against forced heirship rules and community property provisions
- Protection of trust property against foreign judgments and foreign law
- Regulatory framework for private trusts, including provisions for choice of law, disclosure requirements and confidentiality
- Taxation regime for trusts and beneficiaries
- Framework for foreign exchange control

Erstwhile Inheritance tax : overview

1

Currently India does not levy any Inheritance Tax - Was levied in India under the Estate Duty Act, 1953 - Rates of Estate Duty (in 1985)

- Basic exemption limit - Rs 1.5 lac
- Staggered rate - Starting at 10% ; Estate > Rs 20 lacs taxed at 85%
- Estate duty reduced by 10% - 50% on quick succession of property due to death of inheritor

2

Estate duty – tax on the fair assessment of value of assets passing on the death of the deceased

3

However, the levy of Estate duty was abolished with effect from March 16, 1985

- Believed to be double taxation of the same property - Wealth tax before death and estate duty after death
- Revenue from estate duty was much lower than its cost of administration

4

Erstwhile Government in India had proposed a debate on re-introduction of inheritance tax in India ahead of budget in 2013

5

As per media reports, Government may propose inheritance tax in future

Discretionary Trust : Taxation

Taxation of Discretionary Trust

- In case where all beneficiaries are individuals, the status of the trust ought to be the same as the status of the beneficiaries, i.e. an individual
- The income of the trust (in which all beneficiaries are individuals) chargeable to tax at maximum marginal rate
- Specific income heads like capital gains, dividend etc. should continue to be taxed at concessional rates
- Income of beneficiaries received on distribution from trust (which is already taxed in the hands of trust) should not be regarded as income which is liable to tax
- Any contribution made to the trust settled for the benefit of relatives is not taxable (section 56(2)(x) of the Income-tax Act, 1961 – timing for contribution of assets to the trust crucial in such case

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Taxation of Private Trusts

Specific Trust

Where Trust's income does not include business income

Section 161(1)

- Trustees are taxed in the like manner and to the same extent as the beneficiaries
- Assessment to be in same status as that of each of beneficiaries

Where Trust's income includes business income

Section 161(1A)

- Taxable at MMR – subject to exceptions discussed in **Note 1**

Discretionary Trust

Where Trust's income does not include business income

Section 164(1)

- Taxable at MMR – subject to exceptions discussed in **Note 2**

Where Trust's income includes business income

Proviso to Section 164(1)

- Taxable at MMR – subject to exceptions discussed in **Note 1**

Trustee may be taxed in representative capacity in both specific and discretionary trust

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Taxation of Private Trusts

<u>Note 1:</u>

Rates applicable to Individuals will be charged if all the following conditions are satisfied:

- **Trust is declared by a settlor by way of a Will; and**
- Trust is declared exclusively for the benefit of any dependent relative; and
- Such Trust is the only trust so declared by him

<u>Note 2:</u>

Rates applicable to AOP will be charged in a case where:

- None of the beneficiaries:
  - has taxable income exceeding the Basis Exemption Limit; or
  - is a beneficiary under any other private Trust

<u>or</u>

- <u>Where the relevant income or part of the relevant income is receivable under a trust declared by any person by Will and such trust is the only trust so declared by him;</u>

<u>or</u>

- Where the trust was created before 1-3- 1970 by a non-testamentary instrument and the AO is satisfied that it was created *bona fide* exclusively for the benefit of the dependent relatives, or where the settlor is HUF, exclusively for the benefit of the dependent members

<u>or</u>

- Where the relevant income is receivable by the trustees on behalf of a provident fund, superannuation fund, gratuity fund or pension fund or any other fund created *bona fide* by a person carrying on a business or professional exclusively for the benefits of his employees.

Discretionary Trust - Issues

- **Option to assess beneficiaries also open in case of a discretionary trust**.
  - *Kamalini Khatau (1994) (209 ITR 101)(SC)*
- For MMR, surcharge to be based on income level of trust / beneficiaries or surcharge applicable to highest slab
  - *Tayal Sales Corporation [2003] 1 SOT 579 (HYD.)*
- MMR in respect of income for which special rates have been prescribed under Chapter XII (Capital gains, dividend etc.) to be such special rates?
- Access to basic exemption limit to discretionary trusts ?
- Availability of deductions u/s 80C, 54F, 54EC to discretionary trust etc. where all beneficiaries are individuals?

Specific Trust - Issues

- The character of the income, i.e., dividend, interest, capital gains, etc., shall remain same for the trust as it would have been in the hands of the beneficiary
- In case of specific trust the beneficiaries can avail basic exemption limit and exemptions under Section 54F, 54EC etc.
- Loss incurred to trust can be claimed by the beneficiary proportionate to his share while computing his tax liability
- Whether entire income or only business income taxable at MMR ?

FEMA aspects

Following factors are relevant in determining whether a particular trust structure shall entail any implications under FEMA:

- Residential status under FEMA of the settlor, trustee and beneficiaries of the trust
- Governing laws under which the trust has been incorporated viz. whether the trust is an Indian trust or offshore trust
- Location of assets settled in the trust (e.g. shares of an Indian company, immovable property in India, immovable property abroad, shares of a foreign company etc.)

FEMA aspects

- Can an Indian trust be set up with non-resident beneficiaries?
- Impact on distribution of properties from Trusts to non-resident beneficiaries?
- Would it make a difference if the trust is specific or discretionary?
- Can an Indian resident set up a foreign trust with non-resident beneficiaries?
- Can an Indian resident settle his foreign assets (not acquired out of the funds held overseas) in a foreign trust?
- Can non-residents be appointed as trustees of Indian Trust?
- Is there any restriction on residents from becoming beneficiaries of a foreign trust?

SEBI Implications

- Migration of shares of a listed company to a trust would require dispensation from SEBI under Regulation 11 of Takeover Code
- SEBI Circular dated 22 December 2017 lays down points that would be considered by SEBI while granting dispensation in above cases
- Key conditions stipulated in the SEBI Circular from grant of dispensation
  - Only individual promoters or their immediate relatives or lineal descendants are Trustees and beneficiaries – corporate trustees and beneficiaries not permitted
  - No layering in terms of trustees / beneficiaries - sub-trust structure not permitted
  - Reporting requirements in case of change in trustees / beneficiaries
- Where trust is **already a part of promoter and promoter group holding certain shares of listed company, exemption under Regulation 10(1)(a)(ii) of Takeover Code available** if the transferors and trust have been named as promoters in shareholding pattern filed for at least 3 years
- In case of **transfer of shares to a trust under a will, exemption under Regulation 10(1)(g) of Takeover Code may be explored**
  - Regulation 10(1)(g) provides for exemption from open offer requirement in case of acquisition by way of transmission, succession or inheritance

Care

Points to consider

Family ideology – Most important

The ideology of the family, the plans, succession. The dynamics inter-se and the ethos of the family to be given foremost importance

Trust Deed – to be carefully drafted

Trust deed to be an important document and needs to be thoughtfully put through – contains important provisions with respect to ownership, control and distribution of income and wealth

Cost Considerations

Due consideration to be given to cost pertaining to migration of assets like stamp duty, income –tax, grand fathering benefits.

Regulatory Compliance

In case of any of the family members are non-residents, citizens of other jurisdictions, assets held overseas – FEMA laws need consideration. Also, SEBI guidelines to be followed in case of promoters looking to migrate shares of listed entity

Setting of Family Office

The family may consider setting up / streamlining family office for proper governance, wealth management and administrative convenience

Protector Trustee

- Protector is a person appointed under the Trust deed to direct or restrain the trustees to ensure that the trustees exercise their administrative and dispositive powers in accordance with the intentions of the settlor
- Families may also opt for an advisory board which is a body constituted under a Trust deed to provide non-binding advice to the trustees. The advisory board may comprise of independent persons who do not belong to the family and is formed with an intent to ensure that there is no discord among the family members and harmony is maintained amongst the family

Caretaker Trustee

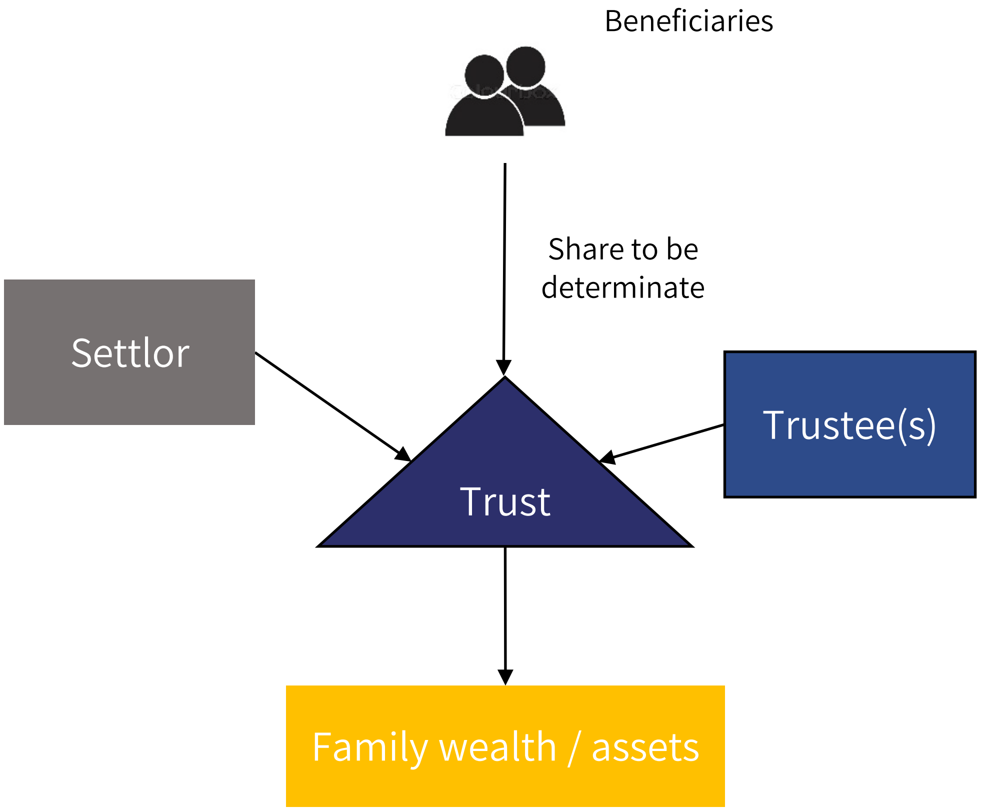
- In case where the original trustees of the trust cease to remain the trustees of the trust either due to demise or any other reason and where the next line of trustee are minor or have not attained certain age as specified in the trust deed, in that case a caretaker trustee is appointed who acts as a trustee till the time the next line of trustees are eligible to become the trustees
- Caretaker trustees to have limited powers
- Caretaker trustee would not have any power to add / remove the beneficiaries nor change key clauses of the trust deed
- Typically, family friend of the original trustee who understands family dynamics is appointed as a caretaker trustee

Migration

- Any succession plan would fail unless it is implemented properly, through appropriate migration of assets to the structure
- Various methods for migration:
  - Settlement into a Trust
  - Gift of assets
  - Sale of assets / business / shares
  - Family arrangement / settlement
  - Primary infusion
  - Mergers / demergers
- Any migration strategy would typically be a combination of the above. Each of the above modes of transfers could have implications under various statutes, which would need to be examined closely
  - Income tax
  - Stamp duty
  - SEBI
  - FEMA
  - Laws of foreign jurisdictions

Case Studies

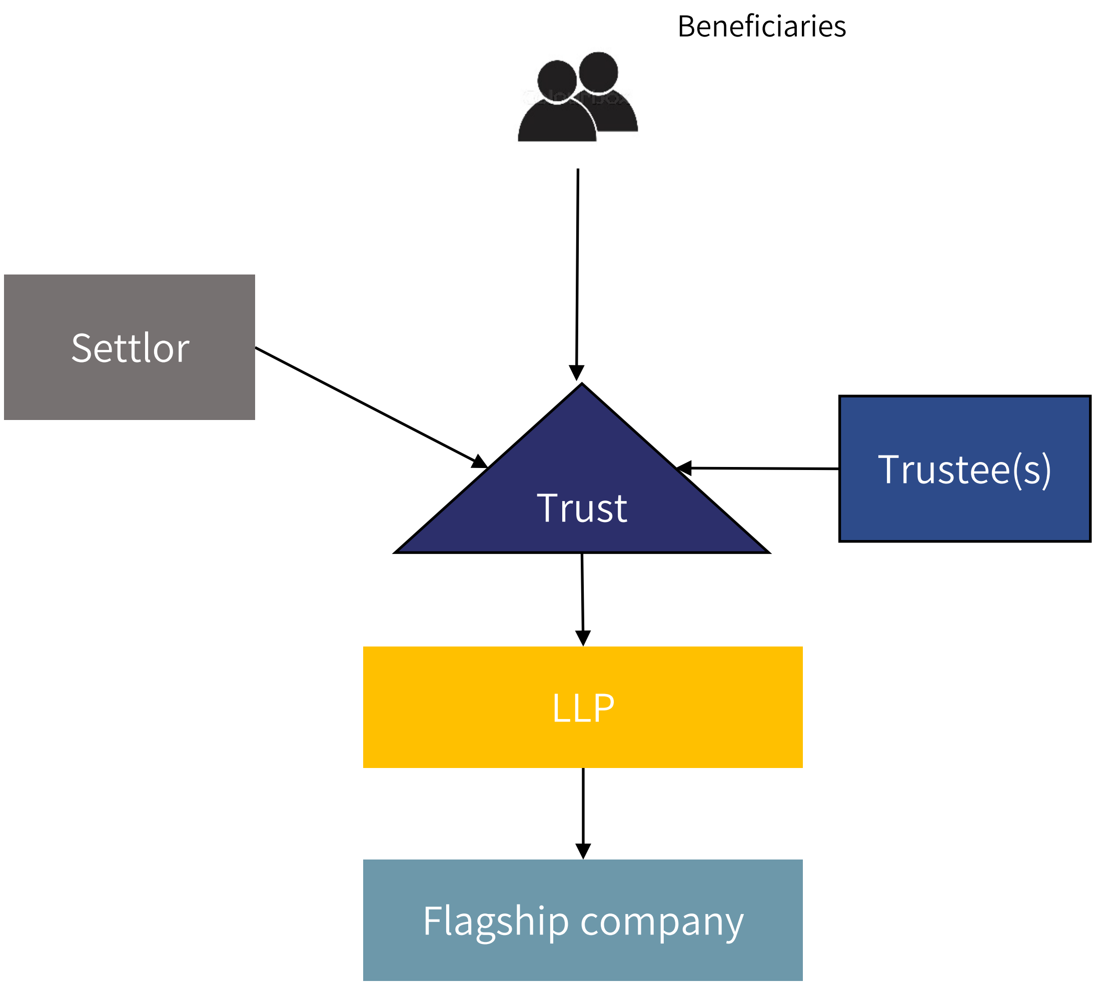
Case Study 1 – Specific Trust



Whether subsequent determination of share of beneficiaries would make the private trust a Specific Trust from an Income-tax perspective?

- Specific Trust is a trust in which the beneficial interests of the beneficiaries are determinate and specific in terms of Trust deed
- Explanation 1 to section 164 of the Income-tax Act ('IT Act') provides that the individual shares of the persons on whose behalf or for whose benefit income is received by the trust shall be deemed to be indeterminate or unknown unless the individual shares of the persons on whose behalf or for whose benefit such income is receivable, are expressly stated in the instrument of trust and are ascertainable as such on the date of such instrument
- Requirement as to specification of share of beneficiaries in the trust deed as also determination of such share 'as on the date of trust deed' are both cumulative conditions to be satisfied for a trust to be considered as a specific trust

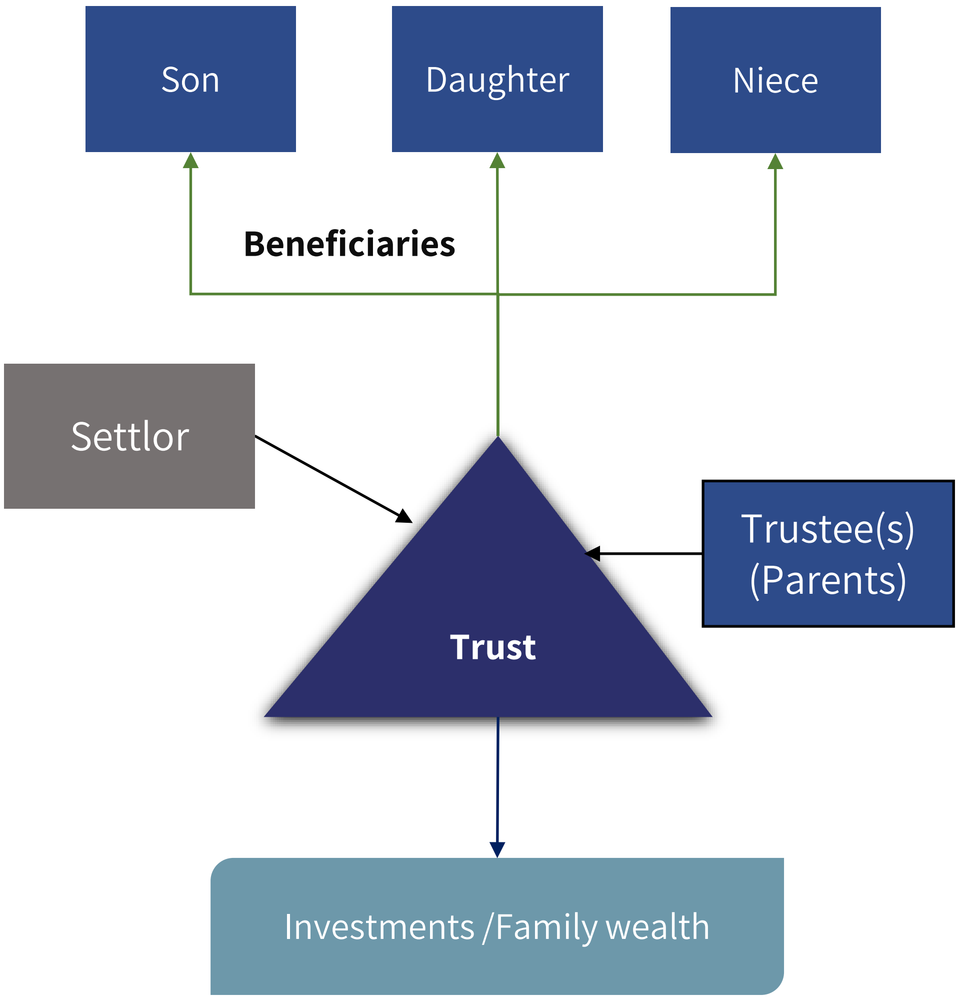
Case Study 2 – Indirect holding in flagship companies by trust through LLP



Whether a trust is eligible to become a partner in an LLP?

- Section 5 of the LLP Act provides that any individual or body corporate may be admitted as a partner in an LLP
- Section 20 of the Trust Act does not prohibit trust money to be invested in an LLP
- General Circular No. 37/2014 issued by the Ministry of Corporate Affairs on October 14, 2014 ("Circular") which clarified that a trustee, including a body corporate, representing a REIT can become a partner in an LLP

Case Study 3 – Gift to trust where Niece is a beneficiary



Whether contribution made by Parents to the Family Trust where the beneficiaries are their son, daughter and niece would have any tax implications?

- Clause (X) of proviso to section 56(2)(x) of the Act provides express exemption for receipt of property by trust from an individual if such trust is created or established **solely for the benefit of relatives** of such individual
- There is also a generic exemption under clause (I) of the proviso for **receipt of property by an individual from any relative**. While evaluating exemption under proviso (I), it needs to be tested whether recipient is a relative of donor
- For claiming exemption, Relationship to be tested from donor's perspective or from recipient's perspective?
- Would such gift by Parents to a trust in which Niece is a beneficiary would be regarded as exempt?

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